Exhibit A

R.C.A.

03 SEP 29 PM 3:06

STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners: Mark K. Johnson, Chair
Kate Giard
Dave Harbour
James S. Strandberg
G. Nanette Thompson

In the Matter of the Petition by GCI COMMUNICATIONS CORP. d/b/a GENERAL COMMUNICATION, INC., and d/b/a GCI for Arbitration under Section 252 of the Telecommunications Act of 1996 with the MUNICIPALITY OF ANCHORAGE d/b/a ANCHORAGE TELEPHONE UTILITY a/k/a ATU TELECOMMUNICATIONS for the Purpose of Instituting Local Exchange Competition	)	U-96-89

PREFILED OPPOSITION TESTIMONY OF DAVID C. BLESSING ON BEHALF OF ACS OF ANCHORAGE

1. Q. Did you file direct testimony in this Docket?

A. Yes. I submitted prefiled direct testimony dated August 29, 2003.

2. Q. What is the purpose of this testimony?

A. To address issues raised by GCI witnesses in their August 29, 2003 filing. I will address GCI's proposed UNE loops rates and issues related

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 276-8533
FAX (907) 276-8536

to the maintenance, common and general support, cost of capital and wholesale discount percentage. I will address potions of the testimony of the following GCI witnesses: Dr. Mercer, Messer's. Brand and Menko, Dr. Cabe and Ms. Murray.

3. Q. **What was your overall impression of GCI's proposals?**

A. I was surprised at how low GCI's loop rate proposals were, and I was amazed that the cost of capital proposed by Ms. Murray was 200 basis points (2 full percentage points) below ACS' actual cost of debt, which is unreasonable. I also was disappointed that Dr. Cabe claims that his proposed wholesale discount of 33% is compliant with the U.S. 8th Circuit Court of Appeals ruling. It is not. GCI used hundreds of pages of testimony to justify these proposals and the inputs and methodologies that support them. However, as I discussed in my direct testimony, one way to evaluate all of this is to look at the end result. If the end result is unreasonable then it follows that the inputs and methodologies are unreasonable. Loop cost proposals of $4.84 and $7.08 and a post 8th Circuit wholesale discount of 33% are unreasonable. GCI's proposals are clear indicators that they are not interested in the adoption of UNE

TINDALL BENNETT & SHOUP, P.C.
598 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

rates that will approach the true forward-looking cost of providing these elements in Anchorage.

4. Q. Both parties claim that their proposals are consistent with FCC rules and/or intent. How can you explain the differences?

A. It is analogous to the situation where two men think they are Napoleon – one of them must be wrong. Generally in interconnection cases, the differences in proposals are the result of differing interpretations of the FCC's rules. Fortunately, recent events have given us considerable insight into the actual meaning of these rules. The FCC recently released its Triennial Review Order which provides some guidance. [1] On September 15, 2003 the Commission released a Notice of Proposed Rulemaking (NPRM) designed to clarify its TELRIC rules.[2] On August 29th the FCC released its order in CC Dockets 00-218 and 00-251, which "resolves disputes regarding the rates Verizon-Virginia, Inc. may charge AT&T Communications of Virginia, Inc. and MCI Worldcom, Inc. for

[1] *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, CC Docket No. 01-338, FCC 03-36, (Released August 21, 2003) (Triennial Review Order).

[2] *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, WC Docket No. 03-173, FCC 03-224, (Released September 15, 2003) (NPRM).

TINDALL BENNETT & SHOUP, P.C.
506 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

access to unbundled network elements, interconnection and resale."[3] In this order, the FCC itself applied its rules to the development of interconnection, UNEs and resale prices. This order provides us with the most complete roadmap available for the application of the FCC's rules. Below I will compare the ACS and GCI proposals and contrast them to the FCC's actions in the Verizon-Virginia matter, in the Triennial Review Order, and the NPRM.

GCI's UNE Loop Rate Proposal is Unreasonable

5. Q. Please describe the UNE loop rate proposals made by GCI and ACS.

A. Table 1 below shows the rate proposals made by the two parties.

Table 1

	ACS 7.2	ACS 7.2 With Dmd Adj.	ACS7.2-G	FCC-G
UNE Loop Rate	$23.86	$25.88	$4.84	$7.08

[3] *In the Matter of the Petition of WorldCom, Inc. (AT&T Communications of Virginia) Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, CC Docket No. 00-218 (CC Docket No. 00-251), DA 03-2738, (Released August 29, 2003) (Verizon-Virginia Order). At paragraph 4 in this order the Commission states "we apply the Commission's pricing rules to choose the best cost models presented to us and select the appropriate algorithms, network design assumptions and inputs for use in the models."

TINDALL BENNETT & SHOUP, P.C.
509 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

As is described in the direct testimony of Bill Wilks, the differences are not due to the selection of the model platform (ACS7.2 or the modified FCC-SM) but to the inputs.[4] Nonetheless, GCI's version of the 7.2 model yields a result that is significantly below their FCC-SM model result. As is described in the testimony of ACS' engineering witnesses, this is the result of GCI witness Fasset's erroneous changes to the 7.2 network design. The pricing issues before the RCA is this proceeding effectively boil down to the selection of the inputs used in the model. I would therefore recommend that the Commission expend the majority of its time evaluating the cost input proposals.

6. Q. Please describe GCI's UNE loop cost proposals.

A. According to Dr. Mercer's testimony, GCI estimated UNE loop costs using two model platforms, one based on the ACS 7.2 model adjusted by GCI, and the other based on the FCC's Synthesis Model (FCC-SM).[5] The estimated loop cost based on the adjusted ACS 7.2 model was $4.84. The estimate based on the adjusted FCC-SM model was $7.08.

[4] Mr. Wilks describes running the FCC model platform used to derive the current loop rate of $14.92 with the ACS inputs and estimated loop cost at $25.45. This compares to the ACS 7.2 result using the same inputs of $23.86.

[5] Mercer direct testimony at page 5.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

These results are unreasonably low and make one wonder about GCI's motivation. Is GCI trying to estimate the forward-looking cost of provisioning loops in Anchorage, or trying to manipulate the process to achieve a financial windfall?

7. Q. **Please explain why the GCI loop cost proposals of $4.84 and $7.08 are unreasonably low.**

A. There are several reasons why the forward-looking cost of provisioning loops in Anchorage is substantially greater than $4.84 or $7.08.

1) If the forward-looking cost to provision loops in Anchorage is $4.84 or $7.08 as GCI claims, why have they been paying $14.92 to lease UNEs when then could build them for less than half the cost? By building their own facilities for $4.84 per loop GCI would have added as much as $10.08 ($14.92 -$4.84) to their bottom line for each loop they transfer for UNEs to their own facilities. Consider that GCI had over 45,000 UNE loops by January of 2002. Given a customer base of 45,000, plus the lines they actually serve via their own facilities, GCI certainly had the critical mass necessary to make it advantageous for them to build. Since January of 2002 GCI has been billed for over 826,000 individual UNE loop charges. At a savings of $10.08 per loop,

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

GCI could have added over $8 million to its bottom line – if the true cost of provisioning loops in Anchorage is $4.84.

2) GCI likely will claim if they did not build out a copper/fiber network because it is deploying cable telephony. GCI's own cost estimates show this is not the case, however, if the true cost of provisioning loops in Anchorage is $4.84 (or $7.08). As discussed in my direct testimony, GCI says it will cost $750 per home for just the electronics necessary to provision cable telephony. Using GCI's own assumptions regarding lines per home and a conservative aggregate annual charge factor of 30% would yield a cost for electronics alone of $14.42. Some cost also must be assigned to the cable from GCI's switch to the customer premise. Assuming GCI is a rationale economic actor, why would it provision a technology that costs in excess of $14.42 per loop if it only costs $4.84 to provision fiber/copper loops?

3) GCI's own current experience in the Dallas and Aurora subdivisions shows that their cost of building loop plant is similar to that predicted by ACS. As discussed more completely in the opposition testimony of Bill Wilks, GCI's cost to provision loops in Anchorage is slightly higher than the $25.88 rate proposed by ACS, using the same type of construction used in the ACS network.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 276-8533
FAX (907) 276-8536

4) The FCC in the Verizon-Virginia proceeding determined that the appropriate forward-looking loop cost for Verizon-Virginia to be $14.43. This was for the largest LEC in the country with over 60 million access lines and all the economies of scope, scale and buying power associated with that size. To suggest that ACS, a much smaller company, should have a UNE loop rate lower than $14.43, instead of one substantially higher, makes no sense.

5) GCI's proposed loop cost estimates of $4.84 and $7.08 are 33% and 50% of the $14.92 rate GCI proposed in the interim phase of this very proceeding. It is hard to accept that the dramatic change in GCI's position is the result of an objective effort to estimate forward-looking loop costs in Anchorage.

GCI's Cost Inputs are Unreasonable

8. Q. Please describe how differences in the model inputs impact the resulting loop cost estimate.

A. TELRIC models basically operate in a two-stage process. They estimate forward-looking network investment and then estimate forward-looking expenses from that estimated investment. The models rely on two types

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

of inputs. There are material cost inputs for items such as cable, DLCs and installation, and these are expense inputs that determine the amount of depreciation, tax, return, maintenance expense, common support expense and general support expense that are included in the cost estimate. In the models proposed by GCI, these inputs take the form of factors or ratios that are applied directly to the estimated forward-looking investment. Differences in the selection of the material cost inputs will impact the estimated forward-looking investment and the estimated loop cost through the application of the factors. For example, if the expense inputs result in a maintenance factor of 10% and this factor is applied to a forward-looking investment of $100, the forward-looking maintenance expense will be equal to $10 ($100 X 10%). However, if the material cost inputs selected result in investment of $75, using the same expense inputs will lead to a lower estimate of forward-looking maintenance expense ($75 X 10% = $7.50). Thus, the estimated loop cost is a function of forward-looking investment (estimated from the material cost inputs) and the cost factors (estimated from the expense inputs).

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

9. Q. Please describe GCI's proposed cost inputs.

A. The estimated investment and aggregate cost factor implicit in the UNE loop proposals of the parties are summarized in Table 2 below.

Table 2: Forward-Looking Investment and Aggregate Cost Factor

	7.2-G	FCC-G	ACS 7.2
Proposed Loop Cost	$4.84	$7.08	$25.88[6]
Estimated Inv. Per Loop	$552	$385	$918
Aggregate Exp Factor	15%	15%	31%

The GCI rate proposals are the result of much lower investment per loop and much lower aggregate cost factors than those proposed by ACS.

10. Q. How would you explain the difference in investment per loop?

A. The differences appear to be the cost of installation, placement, splicing and engineering allowances more than the cost of the actual material. The opposition testimony of Tony Dassow and Steve Cinelli explain in detail why GCI's assumptions are incorrect for Anchorage on the former costs. GCI does not include all of the activities required to provision

[6] ACS' proposal of $25.88 is based on the extrapolated model result of $23.86 adjusted for the demand loss expected due to GCI's deployment of cable telephony. The aggregate cost factor of 31% shown in Table 2 was calculated using the $23.86 result (31% = ($23.86 X 12)/$918.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

loop plant and uses extremely unrealistic assumptions concerning splicing and engineering rates.[7]

11. Q. Are all of the material cost inputs proposed by GCI based on recent Anchorage experience?

A. No. Footnotes suggest, the inputs proposed by GCI generally are not related to anything that was purchased on installed for use in Anchorage. As seen in Mercer Exhibit RAM-5, many of GCI's material cost and installation inputs are from sources such as "various subject matter experts at AT&T and Worldcom", "HAI experts," etc. These sources do not provide useful information for determining forward-looking loop costs in Anchorage. The FCC's Verizon-Virginia decision provides us with useful guidance here. At paragraph 189 the Commission writes:

> When the Commission adopted nationwide inputs in the universal service proceeding, it expressly cautioned that the use of state-specific data may be more appropriate for use in determining UNE rates. The purpose of this proceeding is to set UNE prices based on the forward-looking cost of providing those UNEs, thus Virginia-specific data are better suited to this purpose.[8]

TINDALL BENNETT & SHOUP, P.C.
505 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 276-8533
FAX (907) 276-8536

[7] For example, in Dr. Mercer's exhibit RAM-5 the source for the installed cost of a fiber signal regenerator input is as follows: "This approximation was obtained from a representative of a major fiber optic multiplexer manufacturer at Supercom '96 in June 1966 in Dallas Texas. ."

[8] *Verizon-Virginia Order* at paragraph 189.

The FCC's own interpretation of the UNE pricing rules calls for the use of local inputs, not the use of inputs derived from other areas or averages from other areas. Many of GCI's cost inputs do not meet the FCC's standard.

GCI's Plant Maintenance Cost Factors Are Not Based on Anchorage-Specific Data and are Unreasonably Low

12. Q. Are GCI's expense inputs based on Alaska and/or Anchorage-specific data?

A. No. In its $4.84 and $7.08 loop cost estimates, GCI used cost factors for maintenance, general support and common support based on GCI witnesses Brand and Menko's "best in class" analysis. Brand and Menko's approach seeks to establish cost factors for ACS using data and relationships from carriers in the lower 48 states.

13. Q. Is this approach appropriate?

A. No. The expense factors to be used to develop Anchorage forward-looking costs should be based on Anchorage data. The FCC in its Verizon-Virginia order was very specific on this point:

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

> "We agree with Verizon that the ratios based on Verizon-specific data are the most appropriate starting point for developing ACFs [annual charge factors] in this proceeding. The purpose of this proceeding is to set UNE prices based on the forward-looking cost to Verizon of providing those UNEs. Although it is appropriate in the universal service context to use nationwide figures, it is preferable to use Verizon-specific inputs when calculating UNE rates for Verizon because it is reasonable to expect that the relationship between investment and expenses may be different for Verizon than it is for other incumbent LECs."[9]

14. Q. Please explain the process used to determine the plant maintenance cost factors adopted by the FCC in the Verizon-Virginia case.

A. The process adopted by the FCC in the Verizon-Virginia proceeding starts with the Part 32 account balances for the investment and the corresponding expense account. For example, to develop the plant maintenance factor for underground cable the process begins with the investment balance in Account Number 2422 and the corresponding expense balance in Account Number 6422. The process adopted by the FCC then adjusts the investment balance to reflect current cost of the investment using a current-to-book ratio. The investment balance adjusted to current cost is then used as the denominator in the ratio of expense to investment. The FCC's plant maintenance factor is given as:

[9] Verizon-Virginia Order at paragraph 136.

TINDALL BENNETT & SHOUP, P.C.
538 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

$ACF_{\text{ug cable}} = 6422_{\text{balance}} / (2422_{\text{balance}} \text{ X Current}_{\text{ug cable value}} / \text{Book}_{\text{ug cable value}})$.[10]

In the Verizon-Virginia proceeding the FCC did not even consider the relationships or balances of any other LEC.

15. Q. Why did Brand and Menko propose the use of benchmarking?

A. According to Dr. Mercer, GCI is proposing the benchmarking approach because "setting ACS-ANC's forward-looking costs based on a reasonable sampling (top 20%) of the most efficient carriers at present at least moves in the direction of efficiency envisioned by TELRIC."[11] Acording to the FCC, this is not what TELRIC envisioned.[12]

16. Q. Do differences in the ratio of expenses to investment indicate differences in the level of efficiency?

A. No. There are many reasons why differences in expense to investment ratios exist between companies. These might include differences in the vintage of plant, different reserve ratios and/or different labor costs. Another reason was discussed in my direct testimony; companies may be in different cash positions and have different levels of financial

[10] Please see Verizon-Virginia Order Appendix B.
[11] Mercer reply testimony at page 22-23.
[12] Verizon–Virginia Order at paragraph 136.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

resources. The FCC in the 10th Report and Order in the universal service proceeding explicitly states that differences in expense are not necessarily indicative of differences in efficiency.[13]

17. Q. Please describe how ACS calculated its plant maintenance factors.

A. ACS followed the approach used by the FCC in its Synthesis Model. The 7.2 model contains maintenance expense factors calculated as the ratio of actual expenses to investment brought to current value.

18. Q. Is the ACS-ANC approach consistent with that used by the FCC in Verizon-Virginia?

A. Yes.

19. Q. Please compare the plant maintenance factors proposed by ACS and GCI to those adopted by the FCC in Verizon-Virginia.

A. This comparison is presented on Table 3 below.

[13] *Federal State Joint Board on Universal Service*, 10th Report and Order, CC Docket 96-45, FCC 99-304, (Released November 2, 1999, at para. 348 (USF 10th Report & Order).

TINDALL BENNETT & SHOUP, P.C.
500 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

Table 3: Comparison of Plant Maintenance Factors[14]

	GCI	ACS	FCC-VV[15]
Aerial Cable	1.39%	1.24%	6.57%
Underground Cable	0.17%	0.24%	1.83%
Buried Cable	1.43%	2.52%	5.05%
Digital Switching	0.87%	1.49%	3.23%
Circuit Equipment	0.58%	2.69%	1.34%
Conduit	0.01%	0.02%	0.38%

The plant maintenance factors proposed by ACS are, in all but the case of Circuit Equipment, significantly less than those ordered by the FCC in Verizon-Virginia. This fact alone calls into question Brand/Menko's conclusions. If, as Brand/Menko conclude, ACS is inefficient, it means that Verizon-Virginia, part of the largest LEC in the country, is substantially more inefficient. Second, assuming that Verizon-Virginia is less efficient than Brand/Menko's "best in class," the FCC still adopted the Verizon-specific data. As is made clear in the Verizon-Virginia Order, we are attempting to develop UNE rates for a specific company. Therefore, the data from that company should be used to develop cost factors.

[14] A comparison of the plant maintenance factor for poles is not included in the table because ACS rents many of its poles. The rent payments are included in the plant maintenance account with no corresponding investment. This tends to greatly overestimate the plant maintenance factor. Since poles are not used in the ACS7.2 model I have not made any attempts to adjust the ratio.

[15] The cable factors from the Verizon-Virginia are weighted average of the current fiber and metallic investment balance.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

GCI's Proposals for Common Cost per Loop Are Unreasonably Low and Not Consistent With GCI's Earlier Petitions

20. Q. Please describe the parties' proposals for common cost.

A. Table 4 below shows the per loop common cost proposed by each party.

Table 4

	GCI - $4.84	GCI - $7.08	ACS – 7.2
Common Cost: per Loop	$0.46	$0.66	$3.02

GCI is proposing a common cost per loop that is less than 25% of the amount proposed by ACS.

21. Q. Is GCI's proposal consistent with its positions earlier in this proceeding?

A. No. In an affidavit signed by Dr. Mercer on November 18, 2002, Dr. Mercer mentions that GCI had estimated the common cost per loop as $5.11.[16] Later in that same affidavit, Dr. Mercer states that a common cost per loop of $3.20 is "somewhat more reasonable."[17] In a later

[16] Mercer 11/18/02 Affidavit at page 13. While Dr. Mercer speaks of common cost per loop of $5.11, what actually found its way into the $14.92 model result was a common cost per loop of $4.10. This figure is still above the $3.02 that ACS is proposing here and many times greater than the GCI proposal of $0.46 and $0.66.

[17] Mercer 11/19/02 Affidavit at page 20.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

affidavit, Dr. Mercer proposes a per loop common support of $3.30.[18] ACS, on the other hand, is proposing a common cost per loop amount of $3.02, less than the $3.20 figure Dr. Mercer found was "somewhat reasonable." Over the course of this proceeding, ACS has been continuously researching and updating its positions as they relate to input values. As a result, ACS has reduced its proposals for items such as common costs. Originally ACS was proposing $4.59 per loop in common support expense. In its current proposals, ACS is proposing $3.02. One would have thought that since ACS' current proposal is less than what GCI proposed in November, an input value for common cost per loop could be stipulated.

22. Q. **How do GCI's proposed common costs per loop of $0.46 and $0.66 compare with the FCC's estimates?**

A. The FCC has two estimates with which a comparison may be made. In § 32.621.4.ii(c) of the FCC's rules they state that per loop corporate operations expense to be assigned to the calculation of unrepeated loop costs for rural companies is capped at $8.74. Starting in January of 2002 this amount is adjusted for inflation. For non-rural LECs, such as ACS-

[18] Mercer 01/24/03 Affidavit at page 10.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

ANC, the FCC estimated the per loop common cost amount for supported services of $7.32.[19] This figure includes common support for non-loop functions supported by the Federal universal service program. In order for GCI's highest common cost per loop of $0.66 to be consistent with the FCC's determination, over 90% of the common cost would have to be allocated to non-loop related functions. This is unreasonable.

GCI's Proposals for General Support Cost per Loop Are Unreasonably Low and Not Consistent With GCI's Earlier Petitions

23. Q. **Please discuss the per loop general support proposals offered by ACS and GCI.**

A. Table 5 compares the per loop general support proposals of the parties.

[19] Please see USF 10th Report & Order, Appendix D.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

Table 5: Comparison of Per Loop General Support Proposals

	GCI - $4.84	GCI - $7.08	ACS – 7.2	FCC-VV[20]
Per Loop General Support	$0.46	$0.67	$7.62	$2.46
% of Total Loop Rate	10.50%	10.45%	29.44%	16.93%

GCI has proposed low per loop general support expenses as compared with the ACS proposal and compared with the result from the FCC's *Verizon-Virginia* proceeding. ACS' proposal is substantially above that of the FCC. The majority of the difference is related to the General Purpose Computers account. Expenses associated with General Purpose Computers account for $4.08 of the $7.62 total proposed by ACS. This result is not unexpected because Verizon is about 200 times the size of ACS. With that many more loops across which to spread these support expenses, one would expect that the per loop cost associated with General Purpose Computers would be much greater for ACS than for Verizon. You certainly would not expect it to be less than Verizon's, as is the case with GCI's proposal.

[20] The general support cost per loop figure attributed to the FCC's Verizon-Virginia decision is calculated based on the total level of general support expenses ($110 million) found in Footnote 401 of the order divided by the reported number of lines (3,724,335) found in Appendix F of the order. This result is then divided by 12 to arrive at the monthly general support per loop amount of $2.46.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

24. Q. How do GCI's proposals in this filing differ from earlier proposals?

A. The per loop general support amount in GCI's $14.92 model run is $1.49.[21] This is two to three times higher than their current $0.46 and $0.67 proposals.

GCI's Proposed Cost of Capital Is Not Consistent With the FCC's Statements and Actions

25. Q. Please describe the cost of capital proposals presented by GCI and ACS.

A. Table 6 presents a comparison of the ACS and GCI cost of capital proposals and compares to that adopted by the FCC in the recent Verizon-Virginia order.

Table 6: Comparison of Cost of Capital Proposals

	GCI	ACS	FCC-VV[22]
Debt Ratio	50.21%	45.00%	20.00%
Cost of Debt	5.84%	8.6%	7.86%
Cost of Equity	10.22%	15.25%	14.22%
WACC	8.02%	12.26%	12.95%

[21] The $14.92 interim UNE loop rate now in effect was based on a GCI run of the FCC-SM model adopted for Fairbanks-Juneau.

[22] The cable factors from the Verizon-Virginia are weighted average of the current fiber and metallic investment balance.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

26. Q. Does the GCI cost of capital proposals meet the standards set by FCC?

A. No. The GCI proposed Weighted Average Cost of Capital (WACC) of 8.02% does not meet the standards set by the FCC in the First Report and Order, the Triennial Review Order or the Verizon-Virginia order. Nor does it satisfy the long-standing cost of capital legal requirement for regulated utilities set by the Supreme Court early in the last century.[23] This standard requires that cost of capital be set so the utility is given a reasonable opportunity to meet its interest obligations and return enough to shareholders to prevent them from removing their capital. In practice it must provide a reasonable opportunity to meet capital obligations. Therefore, the WACC at least must be greater than the utility's cost of debt. This is because equity is considered to be more risky than debt and therefore shareholders will demand a return in excess of the cost of debt. If the WACC is set less than the cost of debt, in order to meet its interest obligations the utility must take return dollars away from shareholders. If shareholders expect this result they will take their capital elsewhere. As shown in Exhibit 2 of my direct testimony, the average cost of debt for ACS is in excess of 10%. GCI's proposed WACC of 8.02% would

[23] The legal citations are provided in my direct testimony and Exhibit DCB-2.

TINDALL BENNETT & SHOUP, P.C.
509 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

not provide ACS with a reasonable opportunity to meet its capital obligations. Earning 8.02% on its investment would not even allow ACS to earn enough to cover its interest obligations (of 10.33%).

27. Q. Does GCI's cost of capital proposal meet the standards set by the FCC in its recent orders?

A. No. GCI's proposed WACC does not meet the standards set in the FCC's Triennial Review Order, the NPRM on TELRIC pricing, or its recent decision in the Verizon-Virginia case.[24] Both parties argue that their positions are consistent with the FCC's rules. On the issue of cost of capital both Ms. Murray and I cite the FCC's First Report and Order, its recent NPRM and its Triennial Review Order as support for our respective positions. However, Ms. Murray states in her direct testimony that the FCC has not provided any quantitative guidance concerning the appropriate cost of capital for UNE rate development.[25] Ms. Murray is wrong. The FCC has provided quantitative guidance (as

[24] GCI's proposal, as described by Terry Murray, uses standard methodologies to develop her estimates of WACC. While her methodologies are standard, her starting point and some of her assumptions concerning the appropriate conceptual approach that should used in developing cost of capital inputs for TELRIC cost studies are not. In this testimony, I will concentrate on these conceptual issues. That does not mean I necessarily agree with how she, for example, developed the inputs used in her DCF and CAPM analyses.

[25] Murray Direct Testimony at page 12.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

well as conceptual guidance). This guidance is found in the FCC's Verizon-Virginia decision. In the testimony that follows I will compare the GCI and ACS proposals to the approach adopted by the FCC in Verizon-Virginia. This comparison will show that the ACS proposal is consistent with the FCC's approach, and GCI's is not.

28. Q. What guidance has the FCC provided concerning the appropriate cost of capital for the development of UNE rates?

A. In the First Report and Order the FCC stated that the currently authorized rate of return at the federal or state level is a reasonable starting point for the appropriate cost of capital in the development of UNE rates.[26] The then current federal authorized rate of return was 11.25% while the state authorized level was 11.16%. The Commission went on to say that the incumbent LEC bears "the burden of demonstrating with specificity that the business risks they face providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital...."[27]

[26] *Implementation of the Local Competition Provisions in the Telecommunications Act of* 1996, CC Docket 96-98, First Report and Order, 11 FCC Rcd 15499, at para. 702, (First Report & Order).

[27] First Report & Order at paragraph 702.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

29. Q. Why is appropriate to use the currently authorized cost of capital as the starting point?

A. TELRIC-based UNE rates are intended to be forward-looking and cost of capital is always forward-looking. The appropriate cost of capital is intended to reflect investors' expectations of future risk. The currently authorized state and federal cost of capital established by the FCC are already forward-looking. They meet the TELRIC criteria.

30. Q. The FCC states that the currently authorized rate of return is the starting point. What factors does the FCC say should be considered when moving from this starting point in a TELRIC study?

A. In the First Report and Order the FCC stated the then-currently authorized rate of return may be adjusted to reflect different business risks faced by the carrier offering UNEs. In the Triennial Review Order the Commission expanded on this notion by stating that "TELRIC pricing is intended to replicate the rates in a market with facilities-based competition, and therefore the cost of capital should reflect the risk of losing customers to other facilities-based carriers."[28]

[28] Triennial Review Order at paragraph 680.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

31. Q. What conclusions can be reached from the FCC's statements?

A. The cost of capital appropriate for UNE rate development should be equal to the currently authorized state or federal cost of capital adjusted for increased business risk due to competition. This risk adjustment should lead to a cost of capital above the currently authorized rate of return.

32. Q. Does the FCC's decision in the Verizon-Virginia case support these conclusions?

A. Yes. As shown in Table 6 above, the FCC adopted a cost of capital of 12.95% for Verizon-Virginia – 170 basis points (1.7%) above the federal rate of 11.25%. This was for a company that does not face anywhere near the competitive risk faced by ACS-ANC – a company that has already lost 50% of the market.[29] In that decision the FCC stated that

[29] Jefferies and Company, which recently initiated coverage of GCI, had this to say about GCI's prospects in the local telephony market and those of ACS: "Alaska is a favorable market for GCI, with good growth demographics, a favorable state regulator, and only a modest degree of competition in each of the company's major segments." Jefferies also noted that "Alaska has given GCI a source of refuge from the heated telecom environment; the company faces few competitors, each with less revenue and market clout than GCI, in our opinion." See Jefferies and Company: Initiating Coverage – September 19, 2003. Attached as Exhibit DCB-6.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

"the cost of capital used in this proceeding must reflect the risks of a market in which Verizon faces facilities-based competition."[30]

33. Q. In light of the FCC's conclusions, is GCI's proposed WACC of 8.02% reasonable?

A. No. The FCC in Verizon-Virginia increased the TELRIC cost of capital 170 basis points above the authorized return to reflect the increase in business risk associated with having to face facilities-based competition. For ACS, the increase in business risk comes not only from facing competition, but also from having already lost 50% of the market to competition. Add to this the fact that the financial risks of ACS are compounded due to leverage in the capital structure. If 12.95% is an appropriate level of the TELRIC WACC for Verizon-Virginia, then the WACC should be as least as great for ACS-ANC. GCI's proposal of 8.02%, almost 500 basis points below that granted to Verizon by the FCC in Virginia, is unreasonable.

34. Q. How does ACS' proposed WACC stack up against the FCC's conclusions?

[30] Verizon-Virginia Order at paragraph 63.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

A. ACS' proposal of 12.26% is certainly much more consistent with the Verizon-Virginia decision, and perhaps a little low. ACS' proposal is based on the cost of capital recently stipulated between the RCA staff and ACS, adjusted for increased business risk. This risk adjustment increased the cost of equity from 13.25% to 15.25%. The result of this adjustment was to increase the WACC from the 11.16% stipulated value to 12.26%. Given the relative business and financial risks faced by ACS in Anchorage and Verizon in Virginia, it appears that the proposed 12.26% is low by the standards employed by the FCC.

35. Q. **Please summarize the FCC's conclusions in the Verizon-Virginia case concerning the cost of debt and compare it with the proposals of ACS and GCI.**

A. AT&T/WorldCom, the CLEC in the Verizon-Virginia case, proposed a cost of debt of 7.86% coupled with a debt ratio of 34.5%.[31] Ms. Murray, on the other hand, proposed for ACS-ANC a cost of debt of 5.84% along with a debt ratio of 50.21%. Generally, lenders consider a higher degree of leverage (higher debt ratio) to be indicative of greater risk. This causes lenders to demand a larger interest rate. Either ATT/WorldCom

[31] Verizon-Virginia Order at paragraph 101.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

and the FCC believe that Verizon is a greater credit risk than ACS, or Ms. Murray's cost of debt estimate is understated. ACS' proposed cost of debt of 8.6% was based on the level stipulated between the RCA Staff and the company in 2002. If we followed the Verizon-Virginia example and used the actual yield to maturity of ACS' debt in the calculation of the stipulated WACC, the resulting cost of debt would increase to 10.33% and the WACC would rise to 13.04%.

36. Q. Please summarize the FCC's conclusions in the Verizon-Virginia case concerning the cost of equity and compare it with the proposals of ACS and GCI.

A. Ms. Murray developed her estimate for the cost of equity using the same efficient carrier standard she used for the cost of debt. Her estimated cost of equity was 10.22%, with an assumed debt ratio of 50.21%. The FCC adopted a cost of equity of 14.37% with a debt ratio of 20% in Verizon-Virginia.[32] Using these values, if we assume that ACS-ANC and Verizon-Virginia face the same business risk, financial theory would dictate that because the assumed debt ratio for ACS is greater than that of Verizon, ACS should have a greater return on equity. All else being

[32] Verizon-Virginia Order at paragraphs 99.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

equal, the greater the debt ratio the greater the cost of equity. GCI's proposal flies in the face of this financial maxim. ACS' proposal, on the other hand, couples a 15.25% cost of equity with a 45% assumed debt ratio. The ACS proposal and FCC's decision in Verizon-Virginia are consistent. No one could reasonably equate the level of risk faced by Verizon in Virginia to be the same as that faced by ACS in Anchorage. They have different levels of financial resources and different degrees of competitive penetration. The fact that Ms. Murray's estimated cost of equity is 415 basis point less than that adopted by FCC for Verizon-Virginia is not reasonable.

GCI's Proposal of a 33% Wholesale Discount Is Inconsistent With Contract Law.

37. Q. **Is GCI's proposed wholesale discount of 33% consistent with the 8th Circuit Courts decision?**

A. No. This is clear from Verizon's and AT&T's arguments in the Verizon-Virginia case. AT&T argued that the FCC should not establish a new wholesale discount until it had conducted a full rulemaking. Verizon countered that the Commission should not retain the then-existing rates. One of the reasons AT&T gave was that lowering the discount would

TINDALL BENNETT & SHOUP, P.C.
536 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 276-8533
FAX (907) 278-8536

further harm an already anemic level of resale competition.[33] Both Verizon and AT&T expected the discount to fall when applying the new standard. GCI's proposed discount of 33% is above the upper level of the proxy range for wholesale discounts set by the FCC in the First Report and Order. Not only is the discount proposed by GCI not in line with the 8th Circuit requirements, it also exceeds the level expected by the FCC under the earlier standard.

38. Q. Did the FCC's decision in the Verizon-Virginia case bear this expectation out?

A. Yes. The FCC's order reduced the discount at 14.68% without the resale of operator services and 13.06% with the resale of operator services.[34] That the "avoided" standard will lead to a lower discount is borne out by the fact that the adopted discounts are below the lower bound of the proxy discount range established by the FCC in its First Report and Order.[35]

[33] Verizon-Virginia Order at paragraph 666.

[34] Verizon-Virginia Order at paragraph 678.

[35] First Report and Order at paragraph 910.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

39. Q. Does Dr. Cabe follow the FCC's interpretation of the 8th Circuit Court's decision?

A. No. While anyone else would expect the impact of the court's decision would be to lower the discount rate, Dr. Cabe's analysis has it increasing by over 25%. His analysis appears to be a study based on the old standard. In fact he almost admits his study is nothing but an avoidable cost analysis as opposed to an actually avoided cost study. He states that the "assumption that expenses that are avoidable will indeed be avoided is implicit in our very definition of the word cost."[36] The statement that any cost that is avoidable will indeed be avoided implies that there is no difference in the "avoidable" and "actually avoided" standards. The 8th Circuit held otherwise.

40. Q. In his direct testimony, Dr. Cabe says that retailing costs "automatically cease when a retail customer terminates service."[37] Do you agree?

A. No. If this were the case then estimating avoided costs would be simple – just add up all retailing costs and divide by the number of lines. Then

[36] Cabe Direct Testimony at page 23.

[37] Cabe Direct Testimony at page 24.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

every time a line leaves, the avoided cost would be equal to that result. That was the basic principal behind the "avoidable" standard. However, under the "avoided" standard, we now are required to estimate the amount of cost that actually will be avoided. In the Verizon-Virginia case, the FCC agreed with Verizon that advertising expenses would actually increase as the company lost retail customers.[38] The 8th Circuit decided how avoided costs should be determined. This rule of law must be followed.

41. Q. Does this conclude your testimony?

A. Yes.

[38] Verizon-Virginia at paragraph 684.

TINDALL BENNETT & SHOUP, P.C.
508 WEST 2ND AVENUE, THIRD FLOOR
ANCHORAGE, ALASKA 99501
(907) 278-8533
FAX (907) 278-8536

Exhibit B

STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners: Mark K. Johnson, Chair
Kate Giard
Dave Harbour
James S. Strandberg
G. Nanette Thompson

In the Matter of the Petition by GCI COMMUNICATIONS CORP. d/b/a GENERAL COMMUNICATION, INC., and d/b/a GCI for Arbitration under Section 252 of the Telecommunications Act of 1996 with the MUNICIPALITY OF ANCHORAGE d/b/a ANCHORAGE TELEPHONE UTILITY a/k/a ATU TELECOMMUNICATIONS for the Purpose of Instituting Local Exchange Competition	)	U-96-89

PREFILED REPLY TESTIMONY OF DAVID C. BLESSING ON BEHALF OF ACS OF ANCHORAGE

1. **Q. Did you submit direct and opposition testimony in this Docket?**

A. I submitted prefiled direct testimony on August 29, 2003, and prefiled opposition testimony on September 29, 2003.

2. **Q. What is the purpose of this testimony?**

A. The purpose of this testimony is to address issues raised by GCI witnesses Mercer, Murray, Tindall and Cabe in their September 29, 2003 filings. Specifically, I will show that, while Dr. Mercer engages in an excruciating exercise to detail "adjustments" to the ACS UNE loop price, his cumulative calculation continues to produce a rate that is inconsistent with the principles set forth in the Triennial Review Order and is unrealistically low.

I will also discuss why Ms. Murray's assertion that ACS' proposed cost of capital is unjustifiably high is flawed. Although Ms. Murray claims that ACS' proposed cost of capital of 12.26% is too high, her opposition testimony does not focus on the actual proposed overall weighted average cost of capital ("WACC") but rather on the individual components. In her rebuttal testimony Ms. Murray chooses to ignore that it is her WACC that is clearly the outlier, deviating significantly from the WACC recently adopted by the FCC in its Virginia Arbitration Order.

Furthermore, I will respond to Dr. Cabe's tortured analysis of ACS' wholesale cost discount, as well as to his misleading interpretation of UNE rate comparisons across the nation.

Finally, I will focus on Ms. Tindall's broad policy interpretations that fail to recognize that GCI, at 50% market penetration, is not the fledgling competitor for whom the UNE rules were written. GCI certainly does not require inappropriately low UNE prices to make its way in the Anchorage communications market.

Response to Mercer Testimony

3. Q. **Why do Dr. Mercer's adjustments to the ACS UNE loop rate continue to produce such a low price?**

A. Dr. Mercer relies on analyses produced by a number of other GCI witnesses, all attempting to produce inputs to the model that when totaled will produce an unreasonably low UNE loop rate ranging from $4.84 to $7.02. As pointed out in my opposition testimony, unreasonable results are the likely product of unreasonable inputs and methodologies.[1] Dr. Mercer manages to total up $21.04 in adjustments in order to achieve a $4.84 UNE loop price for ACS. This is clearly a case of an attempt to make the end justify the means. The $4.84 price is a product of the application of an unrealistically low (and likely illegal) cost of capital, comparisons of expense that are not representative of

[1] Blessing Opposition Testimony, at 2.

conditions in Anchorage, general assertions of ACS' lack of efficiency, and a continuing disregard for the vigorous level of competition already achieved in the Anchorage market. Based on an allegedly logical string of changes, Dr. Mercer produces a UNE rate that is lower than virtually any rate in the United States, regardless of the size of the company and the market.

4. Q. **Is Dr. Mercer's assertion that ACS is an inefficient provider well founded?**

A. No. Not only is ACS an efficient provider by Alaska standards, it is an efficient provider compared to other carriers. In constructing a UNE rate, Dr. Mercer should not ignore inputs that are appropriate to ACS' calculation of a TELRIC price merely because a spurious comparison or default produces a result that is more pleasing to GCI. As demonstrated by my earlier testimony and that of Bill Wilks, it is clear from GCI's own experience in the Aurora and Dallas subdivisions that ACS is operating at a similar level of efficiency to GCI. There is no reason to doubt that these two companies are operating efficiently given the market and their size.

5. Q. Do you agree with Dr. Mercer's claim that is it inappropriate to make comparisons to GCI's costs of provisioning distribution facilities and concentrator equipment in Aurora and Dallas?

A. No. The comparisons are entirely appropriate as they show exactly what it costs to provision loop plant in Anchorage. In his opposition testimony, Dr. Mercer summarizes the conclusions of another GCI witness, Blaine Brown.[2] Both of these GCI witnesses claim that you should not use the recent experience of GCI as a guide to the forward-looking cost of provisioning loops in Anchorage. They could not be more wrong.

The recent experience of GCI (or ACS for that matter) is exactly the real world verification that TELRIC models are generally lacking. The validity of the comparison is further strengthened by the fact that both ACS and GCI use the same contractors to provision loop plant and that both are of similar size and likely enjoy similar degrees of buying power from telecommunications equipment vendors. Thus, you would not expect the costs to ACS and GCI to be dramatically different.

Dr. Mercer and Mr. Brown do have one valid point, though they reach the wrong conclusion based on it. I agree that care must be taken

[2] See Brown Rebuttal Testimony, at 16.

when comparing the actual costs of provisioning loop plant for two subdivisions to the entire Anchorage market. However, this caution is not because of Dr. Mercer's baseless claim that the economies of scale enjoyed by ACS to hypothetically build the entire Anchorage network are much greater than those realized by GCI to build plant to two subdivisions. ACS does not realize these economies because it is not actually replacing its entire network. While the TELRIC pricing models purport to rebuild the entire network at today's forward-looking cost, the degree of equipment buying power enjoyed by ACS or GCI is based on the quantities they are actually buying. GCI is most likely buying as much telecommunication cable and equipment for its cable, long distance, and local telephone operations as ACS. The hypothetical network may lead to hypothetical buying power, but it will not translate into actual price breaks from vendors.

Thus, caution must be taken, not because of economies of scale, but rather, because the costs of building to two high density housing areas are likely to be **less** than those of building to the entire market. Aurora is made up of fourplex housing units, and Dallas consists of duplexes. To the extent that the resulting density is greater for these areas than the average density across the entire market, the per loop cost

of building to Dallas and Aurora will be less than the per loop cost to provision the entire market.

6. Q. **On page 26 of his rebuttal testimony, Dr. Mercer relies on general support and common support expense relationships developed in the Brand-Menko direct testimony to reduce the ACS proposed loop cost by $6.42. Do you agree with this approach?**

A. No. The Brand-Menko direct testimony uses a so-called best-of-class analysis. These types of comparisons can produce misleading results. The following table compares the UNE rates and the common & general cost portion of that UNE rate for interconnection cases that I have been directly involved in.

Company*	Loop Rate (incl. NID)	Common & General Portion
ALLTEL – Jamestown	$19.00	$ 8.42
ALLTEL – Ohio	$30.00	$ 7.82
ALLTEL – Nebraska	$26.56	$11.86
PRTC	$24.05	$ 5.11
ACS – Proposed	$25.88	$10.64
GCI – Proposed 1	$ 4.84	$ 0.92
GCI – Proposed 2	$ 7.08	$ 1.33

*The ALLTEL companies constitute over 2.5 million lines, PRTC is over 1.4 million lines, and ACS is approximately 325,000 lines. (Source: 2001 USTA Phone Facts.)

The ACS common and general expense per UNE is consistent with other mid-size LECs, which by their very size would be expected to have general and support expenses lower than ACS.

7. **Q. On page 52 of his rebuttal testimony Dr. Mercer makes the statement that "If GCI's proposed rate is 'unreasonably' low, the ACS proposal is certainly unreasonably high." Please comment.**

A. It appears that despite all of the computational gymnastics, Dr. Mercer is attempting to hedge his bets and put forth a "split the difference" approach to UNE pricing. This rationale is dependent on assuming that the current $14.92 interim rate is the correct starting point. ACS continues to rely on a TELRIC-based UNE price that is reflective of Anchorage conditions.

Response to Murray Testimony

8. **Q. Do you agree with Ms. Murray's claim that ACS' proposed weighted average cost of capital (WACC) is unjustifiably high?**

A. No. In making this claim in her rebuttal testimony, Ms. Murray chooses to ignore the fact that it is her WACC that is clearly the outlier. Her proposed WACC of 8.02% deviates significantly from the WACC values stipulated

by this Commission in U-01-34(15), used by GCI to develop the current $14.92 interim rate, adopted by this Commission in the Fairbanks/Juneau proceeding, was used by the FCC in its universal service proceeding, was recently adopted by the FCC in its Virginia Arbitration Order. By contrast, the WACC and its components proposed by ACS for Anchorage are entirely consistent with these determinations. Although Ms. Murray claims that ACS' proposed cost of capital of 12.26% is unjustifiably high, her rebuttal testimony does not focus on the actual proposed WACC, but rather on the individual components of an analysis used to verify that proposal.

9. Q. In what way is Ms. Murray's weighted average cost of capital an outlier?

A. As demonstrated in Table 1, below, the WACC proposed by ACS is actually lower than the WACC adopted by the FCC in its recent Virginia order, and Ms. Murray's own estimate is at least 300 basis points below the WACC adopted by the RCA and the FCC in earlier proceedings. As a final indictment, Ms. Murray's proposed WACC fails even to cover ACS' cost of debt. [3]

[3] See Blessing Opposition Testimony, at 22.

Table 1: Comparison of Cost of Capital Proposals

	GCI	ACS	FCC-VV	$14.92 HCPM	FCC Default[2]	U-96-34(15) Stipulation
Debt Ratio	50.21%	45.00%	20.00%	68.30%	44.20%	45.00%
Cost of Debt	5.84%	8.60%	7.86%	10.70%	8.80%	8.60%
Cost of Equity	10.22%	15.25%	14.22%	16.50%	13.19%	13.25%
WACC	8.02%	12.26%	12.95%	12.54%	11.25%	11.16%

10. Q. Does Ms. Murray's focus on the individual components of your testimony, as opposed to the resulting WACC, distort her analysis?

A. Yes. ACS' proposed WACC is based on the WACC accepted by the Commission in RCA Order U-01-34(15) adjusted for a risk premium to reflect the risks of a competitive market. The addition of a premium to reflect competitive market risk was recommended by the FCC in its Triennial Review Order.[4] The components of the WACC calculation stipulated to in U-96-34(15) are based on a hypothetical capital structure, just as proposed by Ms. Murray. Beyond that, however, Ms. Murray has presented no evidence that indicates the RCA staff agreed to a capital structure, cost of equity, and cost of debt that were not consistent with an "efficient carrier."

She spends considerable energy critiquing my estimation of the WACC and its components for a stand-alone ACS. As explained in my

[4] Triennial Review Order, paragraph 680.

testimony, that analysis was made only to validate whether the risk-adjusted stipulated WACC of 12.26% is still applicable to ACS. It is this methodology that Ms. Murray criticizes for not being applicable for a hypothetical efficient carrier, not the source of the actual ACS proposal.

Ms. Murray proceeds to evaluate each of the components (capital structure, cost of debt, and cost of equity) in terms of whether they are appropriate for an efficient carrier; however, she fails to demonstrate that the resulting WACC or the underlying components proposed by the Company are not appropriate. In contrast, her own proposed WACC of 8.02% is clearly inappropriate and illegal since it is substantially below ACS' cost of debt. Many of her criticisms of the individual components, such as the unusually high beta, are the result of the current level of ACS debt. I have no doubt that Ms. Murray understands the theoretical relationships that result in a high cost of equity being consistent with a high debt ratio. I am equally certain that she understands that when the WACC is calculated, the high cost of equity is weighted with an

extremely low equity percentage resulting in a WACC similar to those allowed by the RCA and the FCC.[5]

Table 1, above, shows that regardless of the capital structure, the resulting WACC used by the RCA and FCC fall between 11.16% and 12.95%. ACS has proposed a cost of capital of 12.26% almost at the midpoint of the range. By contrast, Ms. Murray's 8.02% proposal is over 300 basis points below the low end of the range. After criticizing the ACS-specific estimate for illustrating what was intended, a company-specific validation of the proposed WACC, she fails to address how it is possible that a WACC almost 500 basis points below what was recently adopted by the FCC for Verizon in Virginia is appropriate for ACS in Anchorage.

11. Q. How has Ms. Murray misinterpreted the cost of capital that the FCC intended to be used to establish UNE prices?

[5] Financial theory holds that as a company becomes more leveraged, the level of risk associated with equity increases, which is reflected in a higher cost of equity. The impact of the higher cost of equity on the WACC is restricted because the higher cost of equity is weighted by the smaller portion of equity in the capital structure. At the same time, a high debt ratio means that the weight applied to the relatively cheaper cost of debt is much greater. The result is that changes in the capital structure will result in offsetting changes in the costs and weights of equity and debt used in the calculation of the WACC. Thus, even with the high debt ratio and the correspondingly high cost of equity, the WACC remains consistent with those calculated using a more balance capital structure. This concept is described in greater detail in my direct testimony.

A. Ms. Murray has stated that "it makes no sense to use an extremely stale FCC figure as a benchmark for the reasonableness of the cost of capital."[6] Clearly the FCC does not agree that the current FCC cost of capital is extremely stale and that it makes no sense to use 11.25% as a benchmark. In the recent FCC Triennial Review Order, the FCC acknowledges that they had indicated that the 11.25% should be the starting point in calculating the cost of capital[7]. The Order then goes on to state that this cost of capital must be adjusted to reflect the risks of a competitive market[8].

12. **Q. In what other ways does Ms. Murray's distort the record to support her unjustifiably low WACC?**

A. Ms. Murray supported her use of lower risk premium by referencing Dr. Ibbotson's opinion that the "historical equity premium no longer reflects investors' expectations and that the forward-looking risk premium is around 4%."[9] This statement was taken out of context. The 4% return that Dr. Ibbotson was speaking about was a geometric return and not the arithmetic average that properly serves as the basis of the historical risk

[6] Murray Rebuttal Testimony, at 49.
[7] Triennial Review Order, at paragraph 677.
[8] Id., at paragraph 680.
[9] Murray Direct Testimony, at 39.

premium. In Dr. Ibbotson's 2003 Yearbook (referenced by Ms. Murray), Dr. Ibbotson explains why the arithmetic average should be used for the purposes of calculating the cost of capital and why the geometric average should be used for repeating past performance, the context of the 4% return. This matter is made clear in an article coauthored by Dr. Ibbotson.[10] In this article, Dr. Ibbotson states that "contrary to several recent studies, our supply side model forecast of the equity risk premium is only slightly lower than the pure historical return estimate"[11] Dr. Ibbotson goes on to clarify that the 4% risk premium cited by Ms. Murray is the geometric average and that the corresponding arithmetic average is about 6%.

Response to Cabe Testimony

13. Q. **In his rebuttal testimony, Dr. Cabe continues to propound a wholesale discount percentage in excess of 30% by attacking the ACS methodology. Are the calculations put forth by Dr. Cabe meaningful?**

[10] Roger G. Ibbotson and Peng Cheng, "Long-Run Stock Returns: Participating in the Real Economy," Financial Analyst Journal, vol. 59, no. 1, at 88-98 (January/February 2003).
[11] Id., Abstract.

A. To show why ACS' wholesale discount rate should be extremely high, Dr. Cabe has put forth an almost random collection of thoughts, including an obscure discussion of the "conundrum of separations" in his direct testimony. Neither the FCC nor the state commissions have provided much guidance in the calculation of a wholesale discount rate, but the results speak for themselves: under a true avoided cost standard, wholesale discount rates do not fall into the 30% range. ACS is willing to rely on the wholesale discount methodology that resulted from the FCC's Virginia arbitration order. This approach would provide a clear and current road map for the calculation of an avoided cost discount.

14. Q. **In both his direct and opposition testimony, Dr. Cabe compares ACS' proposed UNE rates with those adopted in other states. He concludes that these comparisons prove that ACS' proposed UNE loop rate is unreasonably high. Do you agree with his conclusions?**

A. No. Dr. Cabe's analysis is overly broad, and to the extent it supports the conclusion that the ACS proposal is unreasonably high, it also provides evidence that GCI's proposals are unreasonably low. Dr. Cabe's main source of data for his comparison is a study of UNE rates in various states that is updated periodically by Billy Jack Gregg of the West

Virginia Office of Consumer Advocate. The vast majority of UNE loop rates contained in the study are those of the Bell Operating Companies (BOCs). Missing are the rates that are designed to represent the forward-looking loop costs of markets and companies similar to ACS. For instance, while the line weighted average loop rate reported by the Gregg study was $12.53 it should be noted that this average is derived from the zone weighted average of each BOC study area in each state. Not surprisingly this average is skewed toward the UNE rate in the higher density, lower priced zones.

While a simplistic density comparison is appealing, a similar comparison using population density for ACS and other mid-size LECs yields a different result.

Company	Population Density[12]	Loop Rate
ACS-ANC	284*	$25.88
ALLTEL – NE (metro Lincoln)	3022	$24.46
PRTC	1112	$24.05
Citizens NY (metro Rochester)	6132	$ 9.99
CBT – OH	4249	$10.59

*Population density for Anchorage reduced by 500,000 acres to exclude Chugach State Park.

The point of this is that while density is a driver of costs, UNE rates – particularly average UNE rates – can yield a variety of outcomes when measured against study area densities. UNE rates as published in the Gregg study are not pure TELRIC rates; they are driven by factors such as Section 271 requirements, merger conditions, and a variety of issues that are not necessarily cost related. Even assuming the UNE prices were totally cost based, the FCC has recognized in issuing the TELRIC

[12] Population density figures derived from U.S. Census Bureau data. Please see: http://factfinder.census.gov/servlet/BasicFactServlet?_Basicfacts=1&mult1=8626312&geo2=ST-7&_current=&_action=_SLSelected&_child_geo_id=undefined&_lang=en
Anchorage population density value found in the Census Bureau data is significantly different from the access line density of 1,439 lines per square mile reported by Dr. Cabe in his Opposition Testimony. This difference reflects the unique geographic characteristics of Anchorage. Using access line density the figure reported by Dr. Cabe is within the range of Rochester (2,541), Cincinnati (1,586) and Lincoln (776).

NPRM that there has been considerable variation in how different states have interpreted and applied the TELRIC rules.

The real test for establishing a UNE price is what does it cost to build in Anchorage? Aurora/Dallas and ACS vendor prices provide us with the information to determine that cost.

15. Q. **In her rebuttal testimony, Ms. Tindall contends that "...setting UNE rates at the correct point continues to be essential to a competitive market even as competition matures and becomes robustly competitive."[13] What is the "correct" point for setting UNE rates when competition becomes robust?**

A. The 44% market penetration achieved by GCI in the Anchorage communications market meets and likely exceeds any standard of competitive robustness. Ms. Tindall seems to believe that the Telecom Act was intended to be pro-competitor and not pro-competition. The UNE pricing rules were never intended to be a perpetual support mechanism to allow vibrant competitors – an attribute clearly assignable to GCI – to avoid making "buy vs. build" decisions. At paragraph 3 of the Triennial Review Order, the FCC stated "We are aware that

[13] Tindall Rebuttal Testimony, at 2.

excessive network unbundling requirements tend to undermine the incentives of both incumbent LECs and new entrants to invest in new facilities and deploy new technologies. While below cost UNE prices, like the interim $14.92 that GCI currently pays for leasing a loop from ACS, may make some sense when inducing competitors to enter a market, they are entirely unnecessary when a competitor is as successful as GCI. In its recently released TELRIC NPRM, the FCC addresses the issue of setting "correct" UNE prices. They restate the UNE pricing objectives:

> Because the Commission designed UNE prices to serve two objectives – **providing appropriate economic signals with respect to efficient competitive entry** and investment while providing incumbent LECs with the opportunity to recover the forward-looking costs of providing UNEs – determining whether UNE prices for a given carrier in a given state have been set at the "correct" level is an extremely complicated task.[14]

Given the level of competition achieved in Anchorage, there should be little question that a state of competition exceeding "entry-level" has been achieved.

[14] TELRIC NPRM, at paragraph 39 (emphasis added).

16. Q. Ms. Tindall equates "correct" UNE prices as the cornerstone of the Telecommunications Act of 1996. Is that what the TELRIC pricing rules were intended to do?

A. While the Telecom Act obviously sought to foster local competition, the TELRIC rules are actually a much narrower construct. As Ms. Tindall recognizes, TELRIC prices were intended to be set at a level that would allow a competitive entrant to make a rational decision to buy facilities from the incumbent or build its own facilities. The operative term is "entrant." As discussed in my direct testimony, GCI has exceeded entrant status and no longer requires the protections provided by liberal application of the TELRIC rules, even though ACS continues to be prepared to provide UNEs at appropriately established TELRIC rates. Ms. Tindall calls into question ACS' desire to increase UNE prices or even make them unavailable.[15] The FCC's Triennial Review Order sets forth standards for determining the level of impairment. Given GCI's level of entry in the Anchorage market and the investment that they have made in switching and transport, it is worth questioning whether GCI is at all impaired in its ability to provide communications service. Ms. Tindall states that raising UNE rates would compel GCI to speed up its

[15] Tindall Opposition Testimony, at 3.

investment and deployment of its cable telephony network.[16] It is difficult to conceive of this as being an undesired consequence. The response of a new entrant to an increase in UNE rates would more likely be a loss of financial viability and the need to exit a market for economic reasons. By contrast, GCI would merely need to increase the rate of its investment in the marketplace.

17. Q. What are the implications of an increase in UNE prices to the state of local competition in Anchorage?

A. As Ms. Tindall describes, an increase in UNE rates would cause GCI to increase the rate of investment in cable telephony. This would certainly enhance the competitive benefits to the consumer. While pricing UNEs at a realistic level may increase GCI's costs, there is no indication that there are any negative impacts for competition in Alaska.

18. Q. Why is GCI's recent desire to purchase UNE-P from ACS inconsistent?

[16] Tindall Opposition Testimony, at 3.

A. GCI has invested over $36 million in switching and transport capability to provide local service.[17] GCI has indicated that it has more than enough switching capability to provide for the Anchorage market[18] yet now has expressed interest in purchasing UNE-P. It again seems that GCI desires to use below-cost elements leased from ACS in lieu of utilizing its own facilities. This strategy has the dual impact of enhancing GCI's financial situation while simultaneously diminishing ACS'. This is the very impairment issue that the FCC addressed in the Triennial Review Order.

19. Q. Ms. Tindall posits that GCI is ACS' largest customer.[19] How does having such a "customer" benefit ACS?

A. GCI as a purchaser of only below-cost UNEs does nothing to enhance ACS' financial viability. Continued sale of "loss leader" products is not an economically sound solution. Nor is the an opportunity to "make it up in volume" of much consolation to ACS. At best UNE pricing was designed to provide recovery of forward-looking costs, including a return on investment. That objective is not met at a loop price of $14.92

[17] Tindall Opposition Testimony, at 7.
[18] Ms. Tindall states that "GCI has built an alternative switching and transport network." [Tindall Oppostion Testimony, at 6.] That statement indicates a very high degree of ubiquity.
[19] Tindall Opposition Testimony, at 7.

and even less so if UNE loops are priced in the $7 range proposed by GCI. ACS can ill afford any more "customers" like GCI.

20. Q. Ms. Tindall contends that ACS is dominant in the UNE market.[20] Is this true?

A. Ms. Tindall misses the point of dominance. As discussed in my direct testimony, dominance is a function of market power and is associated with the ability to set prices and conditions under which goods and services are provided. The ability of a competitor to lease network elements that are controlled by a regulatory construct is not an example of dominance; if it were, it is clearly a market that ACS would not choose to participate in.

Ms. Tindall states, "In the retail market, ACS has approximately 50% market share, and is arguably no longer dominant."[21] In this only true indicator of market power, ACS agrees wholeheartedly.

21. Q. Would you summarize your reply testimony?

[20] Tindall Opposition Testimony, at 9.
[21] Tindall Opposition Testimony, at 9.

A. GCI continues to provide unrelenting analysis and testimony that seeks to bring ACS' UNE pricing into question. For all the detail and comparative analyses, GCI ignores the fact that the results are unrealistic and that ACS has followed the TELRIC rules. GCI is not a new market entrant and does not require below cost UNE pricing to remain competitive in the Anchorage market.

22. **Q. Does that conclude your reply testimony at this time?**

A. Yes, it does.